

NEW DEVELOPMENTS IN DAIRY FOR 2001

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I want to briefly review a few major developments that are affecting the U.S. dairy industry this year, which should be kept in mind when discussing the dairy outlook. My comments will consist of observations on where the industry stands in its recovery from the present cycle of expansion-induced low prices, coupled with some remarks on some key dairy policy issues.

Regaining Supply-Demand Balance

The dairy industry is in the process of recovering from the largest buildup of the nation's milking herd since the expansion of the late 1970's and early 1980's. At its peak last summer, USDA/NASS reported 100,000 more milk cows than a year earlier. By contrast, during the period between 1988 and 1998, when milk prices were sustained at reasonable levels by market forces, national cow numbers dropped by an average of more than one hundred thousand head each year in order to maintain that supply-demand balance. Recent NASS data show cow numbers are starting to converge with the previous year, and we should expect the milking head to start shrinking again, on an annual basis, sometime this year. Market prices are beginning to come off their year 2000 lows in response.

From the long-term outlook perspective, an interesting question relates to the convergence point where the industry can sustain a balance between supply and demand as it did in the mid-1990's. At that time, it became a rule of thumb that the industry needed to shed at least one percent of the milking herd to stay in balance. That level of herd contraction was needed to counterbalance strong growth in production per cow with somewhat slower-growing commercial demand.

Recent trends in dairy product consumption, however, may be altering this equation. In particular, exceptionally strong growth in demand for cheese and butterfat in all forms in the domestic market, and for whey in the domestic and export markets, may make it possible in the next few years to sustain prices without requiring as large a reduction in cow numbers. If this is the case, and if the current economic downturn does not impact dairy product demand too much, then we could have a quicker, and hopefully sustainable, recovery in dairy than our traditional rules of thumb may indicate. Despite some current market optimism, I think we will have to wait until the second half of this year before we can expect a clear answer to this question.

Policy Issues that Affect the Dairy Outlook

Policy issues are never far away whenever the dairy market situation is the topic of conversation. This is not the place for a policy discussion, but I want to draw attention to a few

issues that are specifically relevant to the dairy outlook and which involve the major dairy policy mechanisms of price support, market orders and import access.

First and foremost, of course, is the fact that the dairy price support program of some fifty years' standing has lost its permanent legislative basis, and has been extended annually for the past two years. This clearly creates some long-term market uncertainty and has required the termination of the program to be explicitly modeled in the various policy baselines from USDA, CBO, FAPRI and others. What will actually happen if and when the program would terminate probably won't really be known until such time as it would occur.

A more immediate issue concerns the price support butter-powder "tilt." Recent changes in federal milk marketing order class pricing formulas, coupled with strong butterfat markets and surplus supplies of nonfat milk solids in the domestic market have somewhat unexpectedly put the price support program back in the business of directly supporting milk prices and dairy producer income, for the first time since the mid-1980's. Prices paid to producers for roughly sixty percent of their milk directly depend, at this time, on the CCC purchase price for nonfat dry milk. This makes the matter of adjusting the butter-powder tilt a bigger issue than it was in the early 1990's, when the CCC purchase price for butter was cut in half, from \$1.32 per pound to \$0.65 per pound over a period of just four years. A key component of the dairy outlook therefore is a USDA administrative action.

Discussion of a butter-powder tilt is clearly being driven by the large quantities of nonfat dry milk currently purchased under the price support program. This surplus of nonfat milk solids, coupled with tight butterfat markets, gives a strong impression that the domestic industry is exhibiting a structural surplus of the former, much as it exhibited a structural surplus of butterfat a decade ago. However, if the growing level of milk protein imports in the non-TRQ categories of milk protein concentrate and casein are taken into consideration, a case can be made that the current nonfat dry milk surplus that is burdening the program is not so much due to a structural surplus of domestic milk production as it is due to an import displacement situation.

With regard to federal milk marketing orders, the current order pricing formulas have been in effect for a little over a year, and we are already seeing some of their effects on the industry. From the perspective of the dairy outlook, one of the key changes has been a lessening of the influence of cheese prices on the entire federal order milk pricing structure than under the previous Basic Formula Price-driven system. In particular, the current Class I price mover has made it more important to be able to forecast, and to understand the forces driving, the relative returns to milk used to produce cheese and milk used to produce butter and milk powder, as are now measured by federal order Class III and Class IV prices.